CONSTRUCTION LAW REPORT

Summer 2005

Tax Break For The Construction Industry

The American Jobs Creation Act of 2004 established a new Internal Revenue Code section 199, which permits qualifying taxpayers to claim a deduction from taxable income attributable to certain domestic production activities, including construction performed in the United States. In general, for 2005 new section 199 provides for a 3% deduction, increasing to 6% for tax years beginning in 2007, 2008, and 2009, and 9% for tax years beginning in 2010 and thereafter.

To qualify, the taxpayer's construction activities must:

- Relate to real property, such as residential and commercial buildings (including the structural components of such buildings); inherently permanent structures other than tangible personal property in the nature of machinery; inherently permanent land improvements; and infrastructure (roads, power lines, water systems, railroad spurs, communications facilities, sewers, sidewalks, cable, and wiring).

- Be performed by a taxpayer engaged in a construction trade or business, such as land development, land subdivision, general contracting, infrastructure construction, and certain specialty subcontracting trades.

- Be performed in connection with "construction activities," such as a project to erect or substantially renovate real property. Tangential services, such as hauling trash and debris and delivering materials, do not qualify as a construction activity unless the taxpayer performing construction is also performing those tangential services in connection with the construction project. Activities, such as improving land (for example, grading and landscaping) and painting, will constitute construction only if those activities are performed in connection with other activities (whether or not by the same taxpayer) that constitute the erection or substantial renovation of real property.

CAUTION: the deduction only applies to gross receipts derived from (1) a sale, exchange, or other disposition of the property constructed or (2) the performance of construction services. Lease or rental income is excluded.

Engineering or architectural services performed in the United States for construction projects in the United States may also qualify for the deduction.

See "Tax Break," page 2

In This Issue

SEYFARTH SHAW ATTORNEYS LLP

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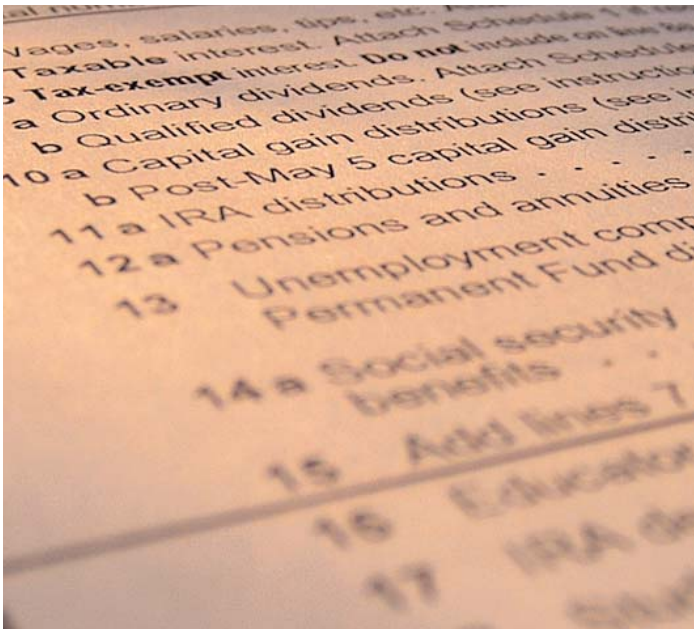
Tax Break, cont'd from page 1

Engineering services in connection with any construction project include any professional services requiring engineering education, training, and experience, and the application of special knowledge of the mathematical, physical, or engineering sciences to those professional services, such as consultation, investigation, evaluation, planning, design, or responsible supervision of construction for the purpose of assuring compliance with plans, specifications, and design.

Architectural services in connection with any construction project include the offering or furnishing of any professional services, such as consultation, planning, aesthetic and structural design, and drawings and specifications, or responsible supervision of construction (for the purpose of assuring compliance with plans, specifications, and design) or erection, in connection with any construction project.

By: Janessa M. Griffin & Roger L. Price



Please be advised that any tax information or written tax advice contained herein is not intended to be used, and cannot be used, by any taxpayer for the purpose of avoiding tax penalties that may be imposed on the taxpayer. (The foregoing legend has been affixed pursuant to U.S. Treasury Regulations governing tax practice).

That Building Is Like A Work Of Art!
Copyright In Architectural Works

It probably doesn't come as a surprise that movies, sound recordings, books and visual art work are protected by copyright. But many in the construction industry are often surprised to learn that a building design may be protected under the United States Copyright Act just like a work of art. Such protection affords the copyright owner the exclusive rights, among other things, to control the reproduction of the building design or the creation of a new structure based upon the original building.

Under the Copyright Act an original design of a "building" embodied in any tangible medium of expression, including the building itself, architectural plans, or drawings, is subject to copyright protection as an "architectural work" under Section 102 of the Copyright Act. A protectable "building" is a structure that is habitable by humans or designed for human occupancy and intended to be both permanent and stationary (for example, a house or office building, museum, gazebo, mosque or concert hall). The protection extends to the overall form of the building and the arrangement and composition of spaces and elements in the design. Excluded from copyright protection are standard configurations of spaces, and individual "standard" features (such as windows, doors, and other staple building components) as well as functional elements whose design or placement is dictated by functional (as opposed to aesthetic) concerns.

Copyright protection applies to architectural works created on or after December 1, 1990, and any architectural works that were unconstructed and embodied in unpublished plans or drawings as of that date. Copyright protection vests in the original design automatically upon its fixation in a tangible medium of expression and registration is not required to establish copyright ownership (although registration affords enhanced remedies in the event of infringement and is a prerequisite to bringing a lawsuit).

Excluded from copyright protection are structures other than buildings (such as bridges, cloverleafs, dams, walkways, and tents), standard configurations of spaces, and individual standard features (such as windows, doors, and other staple building components) as well as functional elements whose design or placement is dictated by utilitarian concerns.

See "Copyright," page 8

Sarbanes-Oxley Act And The Private Contractor

In 2002, Congress passed the Sarbanes-Oxley Act ("SOX"). Since its enactment, SOX has become a standard for good governance principles for businesses, including having independent board members on an audit committee, adopting and enforcing a code of conduct, maintaining rigorous internal controls, and having truly independent external auditors. Lenders and insurers are increasingly looking for governance standards required by SOX in all companies with which they do business.

Most members of the construction community are privately held companies, often family owned and controlled, which, moreover, tend to operate locally. And while the focus and substance of SOX surely was aimed predominantly at companies whose securities are traded publicly and registered with the U.S. Securities and Exchange Commission, SOX does contain some provisions that apply to privately held companies too. For those companies, the following SOX provisions should be of interest.

Cover-up Conduct is Punishable

If any one lesson stands out from recent business debacles, it is that the cover-up may be worse than the crime. SOX addresses the problem in two ways.

(i) The knowing destruction, alteration, or falsification of records in Federal investigation or bankruptcy will result in a mandatory fine or imprisonment for up to twenty (20) years or both.

(ii) Intentionally tampering with or concealing a document or other object or otherwise obstructing, influencing or impeding an official proceeding is punishable by a fine or imprisonment for not more than 20 years, or both.

Retaliation Against Whistleblower is Punishable

SOX provides penalties for intentional retaliation against whistleblowers. Section 806 contains the civil remedies and procedures. Although this provision is aimed primarily at publicly traded companies, it also applies to a "contractor, subcontractor or agent" of such a company. There are very few private companies that are not covered by one of these categories. Section 1107 provides criminal penalties, including, in addition to a monetary fine, imprisonment for up to ten years.

Notice of Blackout Periods Under Defined Contribution Plans Must Be Provided

If a company offers a Defined Contribution Plan, SOX Section 306(b) states that Plan administrators must notify participants in writing at least 30 days prior to any "blackout period." A "blackout period" is defined as any period of more than three consecutive business days during which participants are restricted from diversifying assets in their account or obtaining plan loans or distributions.

By: Thomas R. Howell, Jr.

Do You Have a Seyfarth Shaw LLP Construction Hat Stress Reliever?

If you would like one of our stress hats, please contact Melissa Workman at mworkman@seyfarth.com.

Finally, A Decision On Telecom Build-Outs

Five years ago the tech stock bubble burst. Among the many areas affected was the telecommunications industry. High tech telecommunications companies had real estate developers salivating with their increasing appetite for newer and larger facilities. So the developers naturally went out, acquired more land and created shells for the telecommunications tenants and their suppliers to build-out. When the collapse came, the telecommunications tenants abandoned their leases, leaving owners with premises containing improvements of questionable value and tradespeople with lien claims for unpaid labor, material and equipment.

As companies went out of business and investors lost money, legal questions rose like weeds. Because technology and the law do not move at the same pace, aside from an opinion in California on a preliminary procedural motion, there were until recently no published precedents that directly addressed whether the furnishing of telecommunications hotels was lienable activity. In January, however, the Illinois Appellate Court, in Communications Contractors v. Madison Two Associates discussed the installation of fiber-optic communications cable and conduit. The legal question was whether the cable and conduit supplied by the plaintiff was a "permanent fixture" and therefore lienable or a "trade fixture" and therefore not lienable. The Court held that the material constituted a trade fixture and the supplier lost.

The decision focused on the intent of the principal parties, essentially the owner and the licensor of the telecommunications equipment, the means by which the materials were attached to the premises and whether the items installed were necessary for a particular purpose of the building.

Like many leases between owners and tenants, the license stated that the cable and conduit was removable at the owner's discretion at the end of its term. The Court found, therefore, that the relevant parties (which did not include the supplier) did not intend the improvements to be permanent. The Court also found that the conduit was attached to walls in a way that would allow for easy removal without material damage to the premises. Finally, the Court observed that the cable was not used by any other tenant.

While it invoked an old formula for distinguishing between non-lienable trade fixtures and lienable permanent fixtures, the decision appears to be the first substantive state appellate opinion on telecommunications build-outs. Apparently, no one argued and the Court did not consider the impact of the 2002 National Electrical Code. That code would seem to buttress the Court's opinion as it calls for the removal of abandoned cabling in commercial office buildings.

The case demonstrates once again that new legal wine can be poured from old bottles, that the distinction between trade fixtures and permanent fixtures still lives.

Suppliers beware. Owners and tenants too.

By: Roger L. Price

Inadequate Licensing Can Prevent Ability To Recover

The foundation of a valid mechanics lien claim is the existence of valid and enforceable contract. In many instances, all that is required is for the owner to request somebody to perform some work for an agreed upon sum and the work to be performed. But that is not always the case. With more and more frequency, courts are strictly enforcing licensing requirements against designers and contractors. When those requirements have not been met, courts may find the underlying contract void and unenforceable.

A recent case addressed this very issue. In *G.M. Fedorchak and Associates, Inc. v. Chicago Title Land Trust Company*, 822 N.E.2d 905, the design work was performed under the supervision of a design professional with more than thirty years experience, but whose license was "inactive" under the Illinois Department of Professional Regulations rules at the time that the contract was entered into. According to the Illinois Architecture Practice Act, "[a]ny licensed architect whose license is in an inactive status shall not practice architecture in the State of Illinois." 225 ILCS 605/17. Fedorchak argued that even though the supervising architect's license was inactive, before the work was completed the primary designer became licensed and, thus "cured" the deficiency. Upholding the trial court's dismissal of the lawsuit, the Appellate Court explained that the contract for services was still void because at the time the contract for services was formed, the firm, the principal, and the primary designer were not authorized to practice architecture in Illinois. Consequently, the design firm was prohibited from maintaining a cause of action for either its mechanics lien claim or for breach of contract.

Similarly, contractors can be prohibited from maintaining a cause of action if they fail to obtain a proper license under an applicable state statute. In *Hydrotech Systems, Ltd. v. Oasis Waterpark*, 803 P.2d 370, for example, Hydrotech, a New York subcontractor who was not licensed under California law, was hired to provide and install unique equipment to create a "surfing pool" for a Palm Springs water park. After completing its work, the general contractor failed to pay Hydrotech more than $110,000.00 of its $850,000.00 contract. The California Supreme Court held that despite the inequities, an unlicensed contractor cannot recover either for the agreed contract price or for the reasonable value of labor and materials. It made no difference that, as in the situation here, the person who contracted for the work knew that the contractor was unlicensed.

Many states have licensing requirements governing architects and contractors. The lessened learned is that before entering into any contract, make sure that all necessary paperwork is in place, including corporate registrations, licenses, and individual licenses.

By: Scott J. Smith

Seyfarth Shaw LLP
2005 Construction Newsletter Questionnaire

What do you like best about this issue?
What do you like least about this issue?
What topics would you like to see addressed?

We value your opinion.

Please help us answer these questions by completing and returning the enclosed survey.

Pennsylvania Joins States That Do Not Require Privity to Recover Economic Loss

Under the economic loss doctrine, a contractor may not recover lost profits, cost overruns and other purely economic damages from a design professional with whom it is not in privity of contract. While this once was a powerful defense for design professionals, more and more states are declining to follow it. Pennsylvania recently joined this list.

On January 19, 2005, the Supreme Court of Pennsylvania concluded that a general contractor can pursue a negligent misrepresentation claim for economic loss against an architect even if the contractor was not in privity of contract with the architect. In *Bilt-Rite Contractors, Inc. v. The Architectural Studio*, 866 A.2d 270 (Pa. 2005), the owner contracted with The Architectural Studio (TAS) to design a school and prepare drawings and specifications to be used for a bid package. Bilt-Rite submitted a bid based on the bid package that TAS prepared and was awarded a fixed price general contract for the project. Bilt-Rite alleged that it underbid the project and incurred additional costs because the bid information TAS prepared was inaccurate. Bilt-Rite sued TAS to recover its additional construction costs, which is an economic loss.

Ultimately, the economic loss doctrine rarely absolves a design professional from ultimate liability for its acts or omissions.

TAS sought to have the case dismissed based on the economic loss doctrine. Relying on Section 522 of the Restatement (Second) of Torts, the Supreme Court of Pennsylvania held that the economic loss doctrine does not apply when design professionals have provided information that was relied upon by a foreseeable class of individuals. Finding that TAS either knew, or should have known, that general contractors, such as Bilt-Rite, would rely upon the bid information it prepared, the Supreme Court of Pennsylvania determined that Bilt-Rite had alleged a viable claim against TAS.

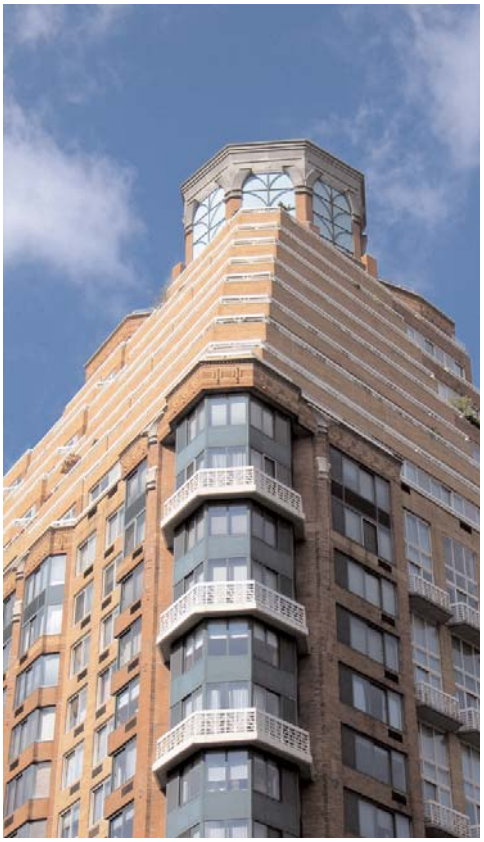
In the majority and dissenting opinions, the court noted that contractors can sue design professionals for economic loss absent privity of contract in Arizona, Georgia, Massachusetts, Mississippi, Montana, North Carolina, South Carolina, Tennessee, and Wisconsin, but that privity is required in Illinois and Washington.

Ultimately, the economic loss doctrine rarely absolves a design professional from ultimate liability for its acts or omissions. Instead, it merely requires that the chain of privity be followed. For example, a subcontractor that alleged it incurred additional costs due to defective design documents prepared by the owner's architect could pursue a claim against the general contractor with whom it entered into a contract. The general contractor could then file a claim against the owner, and the owner could file a claim against its architect.

By: David A. Blake

Copyright, cont'd from page 2

Most commonly, copyright issues in buildings arise where (1) the author of a building design seeks to prevent a builder or building owner from creating a "derivative work" based upon an original design even if such design has been "paid for in full" or (2) where a buyer or builder hires an individual or entity to design plans for a building and without the buyer's or builder's knowledge, the designer copies a work that is protected by a third party's copyright. In the first situation, trouble for the buyer and/or builder may arise because under the Copyright Act simply making payment in full to a third party does not transfer the underlying copyright.



Under the Copyright Act, the "author" of copyrightable work is the owner of the copyright unless the work is a "work made for hire" under the Copyright Act and the copyright is transfered from the author to his or her employer or a commissioning party. In the absence of an assignment or appropriate license from the holder of a copyright in a building, the party for whom a distinctive building is constructed may not have rights sufficient to later expand the structure using the same distinctive design or could be precluded from replicating the design at another location. In the second situation, the issue can often be addressed by including an indemnification and/or insurance obligation in the contract between the buyer and/or builder on the one hand and the party engaged to create the design on the other hand.

By: Jeffrey H. Brown

Presentations

"Advertising Your Firm and Avoiding the Land Mines of Unintended Promises and Prohibited Conduct"

Steve Kmieciak and Larry Watts spoke on this topic at the National Convention of the Associated General Contractors of America.
March 14, 2005, Las Vegas, Nevada

"Contract Clauses: Key Provisions For Estimators"

Mark L. Johnson and Roger L. Price gave a presentation to the Chicago Chapter of the American Society of Professional Estimators.
March 24, 2005, Chicago, Illinois

"The Challenge of New Project Delivery Systems"

Kim Preston spoke on this topic while addressing the Civil Engineering Research Foundation's Corporate Advisory Board.
April 13, 2005, Tyson's Corner, Virginia

"Legal Considerations for the Safety Professional"

Brent Clark spoke on this topic at the annual conference of the American Society of Safety Engineers - New York Chapter.
May, 2005, New York, New York

"Practical Lessons Learned on Design-Build Projects"

Kim Preston spoke on this topic at the National Convention of the American Institute of Architects.
May 21, 2005, Las Vegas, Nevada

"Conflict Resolution, Litigation Avoidance and Hot Topics"

Chip Ingraham spoke on these topics for a CLE Seminar sponsored by the National Business Institute entitled Legal Aspects of Condominium Development and Homeowners' Associations in Georgia.
June 2, 2005, Atlanta, Georgia

Committee Work

Guideline For Workforce Violence Prevention and Response

Mark Lies participated in a select national committee that drafted this guideline which is currently under a public review and comment period. Mark worked with representatives of the FBI, Homeland Security Agency, OSHA, NIOSH, and several Fortune 500 companies.

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